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THE NATIONAL CITY BANK OF NEW YORK

1938

Economic Conditions Governmental Finance United States Securities

New York, May, 1938

General Business Conditions

THE business reports during April have shown no material improvement. The situation at the end of the Winter indicated that, while the decline in industrial activity had plainly flattened out, there was little reason to expect a Spring rise this year; and developments during the month show that this indication was correct. The increase in automobile production, which usually has a pronounced Spring pickup, has been slight, and all business feels the lack of automobile buying. Steel mill operations have dropped a little from the March rate; this is the usual seasonal trend, but is nevertheless disappointing because the March peak was only 36 per cent of capacity. The trade reviews say that new orders for steel have fallen off slightly, and this reflects both the depression in general manufacturing activity and the hand-to-mouth buying policies that are still being followed. Building contract awards slackened during the first half of April, after showing a more than seasonal gain in March.

A few industries, including tires and shoes, give evidence of having improved their position through curtailment, and are doing a little better. Cotton mills have cut operations further, but their sales increased sharply when it became clear to buyers that the piling up of goods on a weak market was to be stopped, and their margins have improved. Business in Fall woolens has been slow despite low prices. Department store sales in dollars have run close to a year ago, thanks to the late Easter; but except for that would apparently be off at least as much as in March, when the Federal Reserve Board's adjusted index was down 8 per cent.

The most important developments of the month, for the long run, have been not in the trade and industrial news, but in Washington. The monetary measures taken by the Treasury and the Federal Reserve Board, the President's message requesting appropriations for a spending and lending program, the defeat of the reorganization bill, and the completion of tax legislation which is substantially less obstructive to business enterprise than the existing law, are all measures of far-reaching influence. Their immediate effect, however, has been limited. A good rally in stock prices from the March lows indicates that these developments, taken together, were interpreted as bullish, but the improvement has not carried through. Commodity prices, moreover, have eased further, with the averages establishing new lows for the depression.

Evidently business men, if more hopeful for Fall, are not counting upon early or rapid improvement, and are indisposed to anticipate it in the markets. With April gone, they are impressed by the fact that seasonal influences are against an upturn between now and August; and they are more concerned at present about reducing inventories and tightening up their operating efficiency than about beating the gun on a hypothetical price rise.

New Monetary Measures and Spending Program

Since the Administration has turned to monetary and spending policies in the endeavor to get business moving forward out of the depression, no question is of as great importance as the relation of these measures to business, the conditions which will govern their effectiveness, and their probable consequences. The country has had experience by which to judge them, and their reception, both in comment and in the markets, has been decidedly mixed.

The monetary-spending program is double-barrelled, as the hyphenated description implies. It contemplates increased spending and lending by Government agencies. Partly for the purpose of financing the spending, it provides for cashing in of one of the Treasury's assets, the $1,400,000,000 of "inactive" gold. This puts the Treasury in funds and will add an equal amount to bank reserves as the funds are spent. It provides also for an immediate increase of $750,000,000 in excess bank reserves, through a reduction of reserve requirements. The piling up of idle bank cash has the double objective of stimulating private lending and

investment, the argument being that the pressure of a huge supply will tend to force some of the money into use, and of facilitating future Government borrowing.

Insofar as the goal of increasing private loans and investment is concerned, it will of course be pointed out that the banks already had large excess reserves, totaling $1,730,000,000 on the statement date preceding the changes, and that the prospective increase to above $3,500,000,000 will add only to a reservoir which was not being used. It is equally true that, as between carrying idle reserves and making loans and investments at excessive risk, soundly-managed banks will unhesitatingly follow the first policy, as they have been doing. Since they are custodians of other people's money, they have no other choice.

This limits the area of prudent credit expansion to loans of good quality and to high grade investments. The banks have unceasingly tried to find good loans throughout the depression, but with small success, for demand from good borrowers, for accommodation which banks can properly grant, is slow.

The chief promise of expansion in loans is in the program of the Reconstruction Finance Corporation, which was authorized in February to resume lending, and has received broader powers from Congress. The R. F. C. will make secured loans on its own account or in participation with banks, or underwrite parts of bank loans. The purpose is to encourage activity through a type of loans which commercial banks, either because maturities are too long or for other reasons, do not ordinarily deem proper. Banks have to be able to pay out their deposits on demand; the R. F. C. does not, hence may properly make sound loans unsuitable for the banks.

Situation in the Bond Market

In the investment account banks of course can take the initiative, and the new measures have had a sharply stimulating effect on prices of Government securities and other highest quality obligations. The limit upon expansion in this area is the high price already commanded by these bonds, and the corresponding risk of market depreciation and ensuing loss of liquidity, irrespective of the soundness of the security. This risk is taken into account in all prudent investment policies, regardless of the cash available for use; and especially when Government deficits, implying continuous borrowing, are recurring without visible end. Hence it is not to be supposed that high grade bonds are on a one-way rise, or that the increase in reserves will lead to anything like a proportionate rise in investments; but whatever credit expansion results from the new measures will occur chiefly through the bond market.

The support given to bonds by the new policies is counted on to influence business by stimulating corporate issues. Here also the considerations which affect bank loans, as above mentioned, will apply. Undoubtedly the bond market will be favorable for high-grade borrowers for a time, and those in that class who need long-term money either for refunding or new uses will be able to get it on favorable terms. However, such borrowers are scarce under present conditions. Refunding issues will help business, for they reduce overhead charges and hence operating costs, which is a stimulus to recovery. But only new borrowing provides for new expenditure upon plant and equipment, which is the essential to get the heavy industries going; and the demand for new money depends upon far more complex considerations than the amount available and the rate at which it can be borrowed. It depends upon the ability to use the money profitably, hence upon costs and markets, and judgment as to their trend; in short, upon the business situation and prospect and the degree of confidence prevailing.

The spending and lending side of the Government program recognizes that private borrowing and investment are backward, and seeks to replace them by a flow of public funds through the economic system. The program includes enlarged loan authorizations to the R.F.C., increased work relief appropriations, public works grants and loans, and a number of smaller proposals. In large part, it is a reversion to the "pump priming" theory of previous expenditures, and to be considered in light of that experience.

The following is a summary of the increases in expenditures and loans which the President recommended to Congress, together with the R.F.C. program already authorized:

(In Millions of Dollars)

(1) Maintenance of Relief:		
(a) Works Progress Administration	+$1,250*	
(b) Farm Security Administration—exp.	+ 75	
" " " —loans	+ 100	
(c) National Youth Administration	+ 75	
(d) Civilian Conservation Corps	+ 50	
Total		+$1,550
(2) Expansion of Public Works:		
(a) U.S. Housing Administration—loans	+ 300	
(b) Public Wks. Administration—grants	+ 450	
" " " —loans	+ 550	
(c) Public roads	+ 100	
(d) Flood control	+ 37	
(e) Federal buildings	+ 25	
Total		+$1,462
Subtotal		+$3,012
(3) Reconstruction Finance Corporation: Amount available for loans under new program	+1,500†	+ 1,500
Grand Total		+$4,512

*For July-January, inclusive. †Approximate.

"Pump Priming"

The theory of "pump priming" is that when private spending is reduced and purchasing power low the Government should borrow and spend; and that in due course this will lead to a resumption of private spending, whereupon the Government support can be withdrawn.

It is undeniable that a dollar of Government expenditure will buy as many goods as a private dollar, although in the long run it will probably do less productive work. If the dollar is obtained by an expansion of bank credit instead of by taxation it will represent, temporarily, a net addition to purchasing power. It is equally undeniable that if the Government pours in enough dollars, raised by borrowing, they will tend to support the business turnover, unless offset by other factors. The qualification is important.

However, there are other economic truths to be considered. One is that if nothing is done to put the economic system in better working order while the priming is going on, the expenditures will be effective only as long as they last; and when they are discontinued the situation will be as before, except that the debts and taxes will remain to burden industry. It is almost inevitable that the pump-priming theory will fail at the point where the resumption of private spending and investment is scheduled to take place, unless policies both within and without the Government are such as to encourage a natural business recovery.

A second truth is that expenditures cannot be continued indefinitely. A third is that they tend to set in motion deflationary influences which counteract their effect. They discourage private investment, and if carried too far may drive capital into hoarding or out of the country. Moreover, their psychological effect diminishes with each use. Like all stimulants, more and more is required to produce less and less. There is abundant experience to prove these statements, in our own depression and in the present situation in France, where huge Government deficits are utterly without stimulating effect, due to other factors.

Undoubtedly the effect of the Government spending during the past five years has been to make many believe that the Government is primarily responsible for prosperity. It is regrettable that this has been the case. Overwhelmingly the greater part of industry, trade and business is carried on by people without governmental assistance. It is a process of exchange of goods and services, between persons and between groups. The important matter in determining whether business is good or bad is whether the relations that exist among these persons or groups are fair and equitable, and the terms of exchange between them practicable. When the elements in the system of exchange are in balance business prospers, and when they are in disorder it is depressed.

These relations for the most part are determined by the people themselves. The Government has striven to alter them in important respects, but not with lasting success; in truth they are so complex as to be almost incomprehensible, and the successful management of the system is impossible by any lesser wisdom or authority than that of the economic law. This being so, the Government cannot accomplish as much for the whole people, in the long run, as they can accomplish for themselves. When business and the national income fall off, and remain depressed for lack of needed adjustments, the Government cannot possibly carry on enough activities of its own to make up for the decline.

Other Elements in the Outlook

The Administration is committed to spending, subject of course to Congressional modification, and the immediate practical question is whether the program is well-timed to help business upward. The comments above make the point that Government spending can be only one of many influences in the business situation. If non-monetary influences continue deflationary the monetary measures will be ineffective, and if the general trend is still downward the addition that the Government makes to buying power may be swallowed up without much effect. On the other hand, if business is ready for a turn by the time the money begins to go out the spending, while it lasts, will augment the upswing.

Obviously no positive answer as to which course will prevail can be given, but the arguments on each side can be presented. The depression is already more than a year old, counting from the top of stock and commodity prices and the falling off in new orders in the early Spring of last year; and in August it will be a year old, counting from the beginning of the violent decline in industrial production. There is no special magic in a twelve-month period as compared with any other, but it is a long time for production to run below ultimate consumption; and in non-durable goods and some durable lines that undoubtedly has been the situation. The first sign of business improvement is expected to appear in the consumers' goods industries, in the cleaning up of stocks of goods, the accumulation of new wants created by wear and tear, and the rise of sales and production once more to the consumption level.

In most consumers' goods lines the absorption of stocks of finished goods has made great progress, as would be expected in view of the extreme curtailment of production. Distributors' inventories are no great barrier to improvement in these lines, the principal weak

spot being the carryover of some Fall goods from the unsuccessful season last year. We have already referred to the reduction in shoe inventories and the signs of turn in that industry, in which production between seasons promises to be better sustained than usual. If cotton mills adhere to their projected curtailment they should clear up surplus goods in time for the Summer selling season and be ready for improvement then. Woolen piece goods stocks are low and the situation in clothing is better, after the dismal Spring season; and Fall business in these lines should pick up. The same will be true in rayon goods in due course, though stocks of yarns in manufacturers' hands are larger than desirable.

The tire industry had a drastic and unseasonal curtailment in the first quarter, with the object of getting inventories down to reasonable levels for the replacement selling season, in Spring and early Summer. The industry's original equipment market evidently will be only about half of last year, but replacement demand is expected to be as large, since the number of cars on the road needing new tires this year is larger than last. Hence production is already rising from the first quarter level.

Reasons for Doubting Further Deflation

The prospect in these industries affords the chief hope for improvement. If consumption experiences a further decline, due to continuation of the deflationary spiral, the gains achieved through inventory absorption will of course be nullified. We are not persuaded, however, that business is in any such spiral. The volume of production and the buying power of factory workers and farmers has had a calamitous decline, but production has been almost steady throughout this year, with the April level probably no more than a point or two below January, and purchasing power is derived from production, while the unemployed are supported by the Government.

A general decline in the volume of credit and bank deposits would be clearly deflationary, but the total of private credit in the banking system is too small to contract drastically, and neither the Government credit, nor the deposits arising out of past purchases of Government bonds, will be reduced at present. Unquestionably the support given to the bond market and the credit structure by the new monetary moves does much to relieve apprehensions of liquidation of investments and contraction of bank credit, and in fact turns the prospect the other way. Withdrawals of foreign funds or flight of American capital would reduce bank deposits and probably involve liquidation of securities, and this is always a threat as long as the foreign money is here. However, it would cause no multiple contraction of credit, such as could occur if bank reserves were not redundant.

In short, the possibility of a vicious circle of credit deflation, such as operated in 1932, is seemingly remote. Business is lower, relative to normal, than in any year in our history except when violent credit deflation was under way; and the absence of depressing credit conditions at this low level itself warrants an assumption of stability.

If consumers' goods industries show the beginnings of improvement during the Summer or early Fall, the question then will be whether business will pass into the next stage, to wit, capital goods improvement. But that complex question may be deferred, as trying to see around too many corners. Unless capital goods join in, no consumer goods pickup by itself can carry far.

It should be noted here that the new tax measure, agreed upon by the Senate and House conferees, is a great improvement over the existing law in respects helpful to investment. The Act reduces the punitive rate on undistributed corporate earnings to a small figure, the maximum rate if all earnings are retained being 19 per cent against the normal corporate rate of 16½ per cent. It exempts from the penalty tax any earnings used to restore impaired capital, or to repay debts contracted before January 1, 1938. It provides a maximum 15 per cent tax on capital gains on assets held over two years, which will make risk-bearing considerably more attractive than heretofore to wealthy men subject to high surtax rates. Hence it strengthens the incentive to saving and investment.

The Bearish Arguments

The bearish arguments on the prospect include the opinion that the losses caused by the great decline in prices and value of securities and commodities will have a greater effect than has yet been experienced, a belief hardly susceptible of either proof or disproof. Another is the argument that the farm situation will be depressed, through big crops, lower prices and reduced income. Farm income is already off from last year, 19 per cent lower in March, and with heavier Government payments to go out hereafter and Government loans in the background, it is doubtful that the showing will become much worse.

The most unfavorable features of the situation are the difficulty in reaching a constructive solution of the railway problem, which hangs over all holders of railway securities; the resistance to readjustment of railway, building, and other wage rates, in industries which can no longer afford to pay the advances made shortly before the depression; and the effects on foreign countries of new currency and exchange difficulties, low prices for their commodities, and political insecurity. Unquestionably the world situation is disturbed; the economic system is rigid, and resistant to change

at points where adjustments should be made to reduce costs and prices and promote trade; labor productivity is not as high, relatively, as wage scales, which holds back recovery and progress; and these and other reasons for lack of confidence dampen the will to spend and invest, and retard the opening of the capital markets.

Money and Banking

Moving forward rapidly in the most sweeping money market maneuver ever undertaken, the monetary authorities commenced last month a series of steps designed to tremendously inflate bank reserves in the hopes thereby of forcing a larger volume of bank credit into use. As explained in our opening article, the program contemplates a dual action, consisting (a) of the release of $1,400,000,000 of sterilized gold and disbursement of the proceeds into commercial bank reserves, and (b) of a reduction of member bank reserve requirements by some $750,000,000, — both together calculated to raise excess reserves to around $3,700,000,000, or higher than ever before. Also, as a corollary to the release of sterilized gold, the Treasury announced that the policy of sterilizing new gold purchases, already modified to apply only to acquisitions in excess of $100,000,000 quarterly, would be abandoned.

Of the two measures determined upon, the one most immediately effective was the reduction of reserve requirements. On April 15, the day following the President's message to Congress outlining the new program, the Federal Reserve Board announced a new schedule of rates applicable to all member banks, to take effect April 16. This schedule is given in the following table, together with the rates previously in effect on different dates since the first increase of reserve requirements in August, 1936.

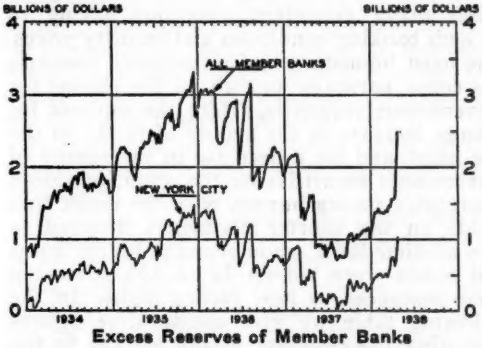
Reserve Requirements of Member Banks
(Percent of Deposits)

	Demand Deposits			Time Deposits
	Central Reserve City Banks	Reserve City Banks	Country Banks	All Member Banks
Prior to Aug. 15, 1936	13	10	7	3
Aug. 15, 1936	19½	15	10½	4½
March 1, 1937	22¾	17½	12¼	5¼
May 1, 1937	26	20	14	6
April 16, 1938	22¾	17½	12	5

As will be seen from the table, the reductions that have been made have restored reserve requirements to about where they were before the last increase on May 1 a year ago, the only difference being a slight further reduction in the requirements against demand deposits of country banks and against time deposits. Inasmuch as time deposits are heavier, proportionately to total deposits, in the country banks than in other groups, the slightly greater percentage reduction on this class of deposits, together with the change against demand deposits, has the effect of freeing somewhat more reserve, relatively, for country banks than for banks in central reserve and reserve cities.

Reflecting mainly the new reserve ratios, combined excess reserves of all member institutions rose $760,000,000 during the week ended April 20 to $2,490,000,000, of which slightly more than a billion was in New York City banks, with both totals the highest since the first increase of reserve requirements was made in August, 1936.

In the accompanying diagram we trace the movement of excess reserves, both for New York City and all member banks from 1934 to date.



Excess Reserves of Member Banks

The Process of Gold Desterilization

Concurrently with the reduction of reserve requirements by the Federal Reserve Board, the Treasury commenced the process of desterilizing approximately $1,400,000,000 of gold held mainly in the inactive account. The first step in this process consisted of depositing gold certificates in the Federal Reserve Banks against the gold in the Treasury. This had the effect of increasing both the gold certificate reserves and the Treasury deposits in the Reserve Banks. Thus, in the week of April 20, the statement of condition of the twelve Federal Reserve Banks revealed an increase of $1,397,000,000 in gold certificates on hand and due from the Treasury to $10,642,000,000, while the item "U. S. Treasurer—General Account" rose from $141,000,000 to $1,428,000,000, or by $1,287,000,000, the difference in the rise of the two accounts evidently being caused by Treasury disbursements during the period. With the Treasury possessed of these additional deposits at the Reserve Banks, the next step is simply that of paying them out in discharge of current obligations, and as the money is spent it goes into the commercial banks and increases their reserves accordingly.

From the foregoing description it will be seen that the maximum effect of desterilization upon the credit base will not be felt immediately, but only as funds obtained by the Treasury through use of the gold are checked out into the market. This process can be speeded

up by using the funds to retire maturing debt, or spread out over a longer period by confining their use to the financing of current expenditures. That the authorities are determined to press forward in their program of forcing excess reserves to a maximum was indicated by the decision of the Treasury, until further notice, to redeem half of the $100,000,000 of Treasury bills that mature weekly between now and the middle of June.

Effects of the Program

Apart from the broad question as to the effects upon general business, which is discussed elsewhere in this Letter, the program raises many important questions having to do with banking conditions and security prices. The most immediate and pronounced response has come, naturally enough, in the market for Government securities. Here the outlook for a huge increase in the supply of funds on the one hand, and for a decrease in the supply of Government securities on the other, produced a scramble among buyers, with the result that yields on the shorter maturities dropped to new all-time lows, while prices of longer notes and bonds were bid up ¾ to 1¾ points, in some instances to new record highs. In the following table we give comparative figures indicating the response of the market to the developments of the month.

Prices of U. S. Government Securities

	1937-1938 High	Market Price Apr. 13	Market Price Apr. 26	Points Increase April 13-26	Per-cent Yield Apr. 26
U. S. Treasury Bonds					
2¾s 1951/48	104.18	102.1	103.24	1.23	2.32
2½s 1953/49	101.21	99.27	101.4	1.9	2.40
2¾s 1954/51	103.17	101.5	102.18	1.13	2.52
2¾s 1959/56	103.17	100.27	102.9	1.14	2.60
2⅞s 1960/55	104.30	102.1	103.12	1.11	2.63
U. S. Treasury Notes					
1½s 12/15/40	102.15	101.23	102.13	0.22	.57
1⅜s 6/15/41	102.4	101.12	102.3	0.23	.70
1¾s 3/15/42	103.16	102.15	103.14	0.31	.85
2's 9/15/42	104.26	103.20	104.23	1.3	.90
1¾s 12/15/42	103.26	102.22	103.25	1.3	.91
Guaranteed Issues					
HOLC 2¾s 1949/39	103.13	101.14	102.30	1.16	.40
HOLC 2¼s 1944/42	103.11	101.11	103.1	1.22	1.50
HOLC 3's 1952/44	105.20	103.13	105.4	1.23	2.08

Note: Quotations after decimals represent 32ds of a point.

First Quarter Profits

Reports for the first quarter that have been published during the past month by 280 leading corporations engaged in manufacturing and trade show combined net profits, less deficits, of approximately $100,000,000, which compares with $309,000,000 for the same companies in the first quarter of 1937, and represents a decline of 67.5 per cent. In the final quarter of 1937, the group had net profits of $210,000,000.

These companies had an aggregate capital and surplus of $10,258,000,000 at the beginning

PROFITS OF LEADING INDUSTRIAL CORPORATIONS FOR THE FIRST QUARTER

Net Profits Are Shown After Depreciation, Interest, Taxes, and Other Charges and Reserves, But Before Dividends.

Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

(In Thousands of Dollars)

No.	Industry	Net Profits First Quarter 1937	1938	Per Cent Change	Net Worth January 1 1937	1938	Per Cent Change	Annual Rate of Return % 1937	1938
6	Amusements	$ 11,089	$7,990	— 27.9	$216,455	$229,265	+ 5.9	20.5	14.0
1	Autos—General Motors	44,814	8,234	— 81.6	970,843	992,305	+ 2.2	18.5	3.3
21	Auto Accessories	8,551	D- 851	—	144,275	146,845	+ 1.8	23.7	......
6	Baking	3,794	4,294	+ 13.2	250,085	248,803	— 0.5	6.1	6.9
20	Building Materials	8,018	729	— 90.9	355,519	379,227	+ 6.7	9.0	0.8
15	Chemicals	36,060	18,509	— 48.7	1,076,946	1,156,890	+ 7.4	13.4	6.4
7	Coal Mining	535	D- 1,401	—	172,311	170,960	— 0.8	1.2	......
5	Drugs and Sundries	3,915	3,408	— 13.0	54,114	55,218	+ 2.0	28.9	24.7
8	Electrical Equipment	18,687	9,100	— 51.3	520,029	525,471	+ 1.0	14.4	6.9
15	Food Products—Misc.	18,789	16,576	— 11.8	574,902	575,334	+ 0.1	13.0	11.5
9	Hardware and Tools	2,644	D- 341	—	52,124	58,141	+11.5	20.3	......
9	Household Goods and Supplies	10,346	4,543	— 56.1	167,320	176,379	+ 5.4	24.7	10.3
1	Iron and Steel—U. S. Steel	28,562	D- 1,292	—	1,564,517	1,592,212	+ 1.8	7.3	......
25	Iron and Steel—Other	40,634	D- 3,634	—	1,516,464	1,662,946	+ 9.7	10.7	......
5	Liquors	1,466	1,607	+ 9.6	51,006	53,199	+ 4.3	11.5	12.1
23	Machinery	8,217	3,888	— 52.7	136,507	155,409	+13.8	24.0	10.0
8	Merchandising	5,151	1,023	— 80.1	256,807	272,608	+ 6.2	8.0	1.5
8	Mining, Non-ferrous	7,737 *	5,292*	— 31.6	200,784	201,049	+ 0.1	15.4	10.5
6	Office Equipment	3,793	1,797	— 52.6	82,539	87,682	+ 6.2	18.4	8.0
10	Paper Products	3,039	2,100	— 32.0	118,730	132,414	+11.5	10.4	6.3
14	Petroleum	20,338	16,111	— 20.8	950,818	987,419	+ 3.8	8.6	6.5
9	Railway Equipment	9,437	D- 370	—	360,310	367,685	+ 2.0	10.4	......
6	Textiles and Apparel	2,844	D- 453	—	53,153	58,274	+ 9.6	21.4	......
33	Misc. Manufacturing	10,211	3,640	— 64.4	282,541	298,645	+ 5.7	14.4	4.8
10	Misc. Services	156	D- 135	—	128,456	127,147	— 1.0	0.5	......
280	Total	$308,877	$100,364	— 67.5	$10,257,555	$10,711,527	+ 4.4	12.0	3.7

D- Deficit. * Before certain charges.

of 1937, and $10,712,000,000 at the beginning of 1938, upon which their first quarter profits for 1937 and 1938, respectively, represented annual rates of return of 12.0 per cent and 3.7 per cent.

From the accompanying summary it will be seen that the changes in profits among the different industrial groups were extremely uneven. Sales of many companies in the amusement, food and petroleum industries were relatively well maintained, and profits declined only moderately. Earnings of some of the large baking companies were above those of a year ago, due in part to lower prices of flour purchased.

In most other lines, however, the trend was sharply downward, and in numerous instances the profits disappeared entirely. The drop was particularly severe in industries such as automobiles and accessories, building materials, electrical equipment, household goods and supplies, iron and steel, machinery, railway equipment, textiles and apparel, and also in merchandising lines.

A total of 91 of the leading corporations that have published statements to date made no profit whatever this year, but suffered a loss of capital instead, whereas in the first quarter of last year only 16 of these companies were operating "in the red".

Trend of Business and Profits

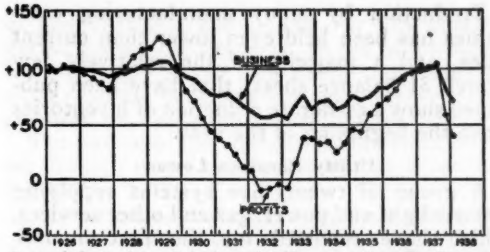
The explanations that have been noted most frequently in the published quarterly reports for this sharp drop in profits, and have been commented upon at recent annual meetings of shareholders, are the decline in volume of sales, combined with the high and inflexible level of expenses for labor, materials and taxes.

When various important items of operating cost were raised abruptly last year, the effect upon profit margins did not become apparent immediately. Heavy back-logs of unfilled orders on the books of many corporations permitted them to continue to produce at high rates of activity.

The slowing down of sales during the latter months of the year, however, caused a "squeezing" of profit margins, followed by drastic efforts to work down inventories, a curtailment of new commitments, and the sharpest drop in industrial production that has ever taken place in this country within a similar space of time.

The accompanying index shows the quarterly trend of profits during recent years, based upon rate of return upon net worth of 200 leading industrial corporations, together with the Annalist index of business activity, both adjusted for seasonal variation. Figures for the first quarter of 1938 are preliminary.

It will be seen that the preliminary first quarter indexes for both business activity and profits were the lowest for any first quarter since 1934.



Quarterly Index of Industrial Corporation Profits and The Annalist Index of Business Activity. 1926 = 100.

Change in First Quarter Sales

As usual in periods of recession, there was a much smaller decline in sales by the merchandising organizations than by the manufacturing corporations. Some of the latter, however, report that new orders booked during the quarter declined much more sharply than did the sales billed during the same period.

Following is a list of some forty of the larger concerns in each field that have published sales figures:

% Change in First Quarter Sales, 1937-1938

Manufacturing		Merchandising	
Air Reduction Co.	—25.6	American Stores Co.	— 7.5
Atlas Powder Co.	—16.2	Barker Bro. Corp.	—20.0
Baldwin Loco. Wks.	+17.1	Butler Brothers	—15.0
Caterpillar Tract. Co.	—35.5	Consol. Retail Stores	— 7.5
Certain-teed Products	—14.1	Crown Drug Co.	— 1.2
Colo. Fuel & Iron	—41.1	Edison Bros. Stores	— 5.2
Container Corp.	—35.0	Fanny Farmer Candy	—14.5
Doehler Die Cast. Co.	—50.1	M. H. Fishman Co.	— 4.7
E. I. du Pont & Co.	—29.7	Grand Union Co.	— 1.0
Flintkote Company	—14.5	W. T. Grant Co.	— 7.8
General Electric Co.	—11.8	H. L. Green Co.	—16.0
General Foods Corp.	— 6.2	Interstate Dept. Stores	—21.4
General Motors Corp.	—25.6	Jewel Tea Co.	+ 6.0
General Refractories Co.	—54.3	S. S. Kresge Co.	— 8.9
Hercules Powder Co.	—30.8	S. H. Kress & Co.	— 8.7
Interlake Iron Corp.	—56.4	Kroger Groc. & Bak.	— 7.6
Johns-Manville Corp.	—19.7	Lane Bryant, Inc.	— 8.7
Kimberly-Clark Corp.	+ 4.1	Lerner Stores Corp.	—12.0
Link Belt Co.	—15.6	McCrory Stores Corp.	— 6.9
Lone Star Cement Corp.	+ 6.2	McLellan Stores Corp.	— 9.9
Maytag Company	—41.1	Melville Shoe Corp.	—13.6
Mead Corporation	—24.8	Montgomery Ward	— 6.7
Mengel Company	—46.6	G. C. Murphy Co.	— 8.1
Minn.-Honeywell Reg.	—31.9	Natl. Tea Co.	—18.3
Natl. Cash Register	+ 2.6	Neisner Bros., Inc.	—12.8
Otis Elevator Co.	+20.9	J. J. Newberry Co.	— 8.6
Phillips Petroleum Co.	— 4.5	J. C. Penney Co.	— 8.5
Ruberoid Company	—26.4	Peoples Drug Stores	— 4.5
Scott Paper Co.	+24.0	Reliable Stores Corp.	—23.0
Sharon Steel Corp.	—67.3	Rose's 5-10-25c Stores	— 7.6
Shell Union Oil Corp.	— 0.6	Safeway Stores, Inc.	— 0.9
Simonds Saw & Steel	—44.4	Sears, Roebuck & Co.	— 5.2
Skelly Oil Co.	— 3.7	Spiegel, Inc.	—19.7
Standard Brands	—16.8	Sterchi Bros. Stores	—14.4
Tide Water Assoc. Oil	+ 3.1	Sun Ray Drug Co.	+ 8.1
Twent. Cent.-Fox Film	— 3.4	Union Premier Food	+38.1
Union Oil Co.	+ 0.3	Walgreen Company	+ 1.3
United Aircraft Corp.	+51.6	Western Auto Supply	+ 2.7
Westinghouse Electric	— 9.9	F. W. Woolworth Co.	— 3.1
Wheeling Steel Corp.	—41.6		

Aggregate first quarter sales of the reporting chain store, department store and mail order organizations declined from approximately $689,000,000 in 1937 to $647,000,000 in 1938, or by 6.1 per cent. The month of March showed a greater percentage decline than did either January or February, due in considerable part to the late Easter.

Sales of the manufacturing group declined from $952,000,000 in the first quarter of 1937 to $778,000,000 this year, or by 18.3 per cent. A number of companies reported gains, despite the general downward trend.

Production by many manufacturing companies has been held even lower than current sales, and a majority of the relatively few March 31 balance sheets that have been published show a moderate reduction of inventories since the beginning of the year.

Utility Earnings Lower

A group of twenty-five systems supplying electric light and power, gas and other services, which have reported for the first quarter showed an average increase of about 1.1 per cent in gross operating revenues as compared with a year ago. Because of higher labor and tax costs, however, their net income after charges was 9.0 per cent lower.

The American Telephone & Telegraph Company and its principal telephone subsidiaries, reporting for the quarter ended February 28, showed an increase of 1.1 per cent in gross operating revenues over those of a year previous. At the same time, operating expenses were 7.8 per cent higher, and taxes 12.4 per cent higher, so that net income dropped 32.2 per cent. The saving this year on interest charges, through having refunded bond issues at lower rates, was offset several times over by increased wage and tax payments.

Railroad Income Drops Sharply

The financial results of the railroads during the first quarter were the worst for any corresponding period since the compilation of monthly data was begun twenty-one years ago.

Gross operating revenues of all class 1 railroads in the first three months were down about 21.5 per cent as compared with a year ago. Net operating income, however, after operating expenses and taxes but before interest charges, dropped by about 87 per cent. In the month of February, all the class 1 systems, as a group, made nothing toward their fixed bond interest, and did not even fully cover operating expenses and taxes.

The railroad shareholders' capital of over $12,000,000,000, considered as a whole, earned no net income whatever during the first quarter. Instead, the preliminary figures indicate a substantial deficit.

The Railroad Problem

Although this country has had a "railroad problem" almost as far back as anyone can remember, the problem has been growing increasingly serious in the years since the war, with major financial crises encountered in 1932-33 and 1937-38 as a result of sharply declining business. At present more than one-third of the total railway mileage of the country is in receivership, and an important share of the remaining mileage has been granted R.F.C. assistance, pending a return of more normal business conditions.

Various factors have been named as responsible for the decline in railroad earnings, among which are loss of revenue to trucks, buses, private automobiles and pipe lines; increased wage rates and labor restrictions; discriminatory taxation; excessive regulation; etc.

Some of this discussion suggests that the elementary facts as to the disposition of the $4,000,000,000 annual railroad revenue may have been lost to view in the countless exhibits of figures, bearing on one phase or another of the subject, that have been presented in recent years.

Last month we reprinted a simplified or "short-form" statement prepared by the United States Steel Corporation for the information of its employes, based upon the audited income accounts and balance sheets that are given in its regular reports to shareholders, but omitting a mass of detail. From such a statement it is easy for anyone to see how the income, after payment for goods and services purchased and other expenses, is divided as between the company's employees, its stockholders, and the "third partner"—Government.

Similar condensed statements for the information of employes and of the public have recently been issued by a number of other leading corporations in different lines of business, including one of the large railway systems—the Illinois Central.

Following is a summary of the operations of all class 1 railroads in the United States, covering the seven-year period 1930-1936, prepared from statistics reported to the Interstate Commerce Commission, but set up in simplified form:

All Class I Steam Railways
January 1, 1930 to December 31, 1936
(000,000's Omitted)

Gross sales	$26,461	
Other receipts	1,585	
Total receipts		$28,046
Cost of sales:		
Goods and services purchased from others	7,480	
Rent for leased lines and equipment	1,080	
Depreciation	1,394	
Interest	3,611	
Total		13,565
Balance remaining		14,481
Divided as follows:		
Wages and salaries (81.8% of "balance remaining")	11,839	
Taxes (13.6% of "balance remaining")	1,973	
Income available to stockholders (4.6% of "balance remaining")	669	
Total		$14,481

It will be seen that of the $28,046,000,000 gross sales (freight and passenger revenues) and other receipts during this seven-year period, almost one-half was required for expenses over which the roads had only limited control, including goods and services purchased from others, rent of leased lines and equip-

ment, depreciation (offset by capital outlays) and interest on borrowed money.

Of the $14,481,000,000 that remained after these expenses, labor received in wages and salaries 81.8 per cent, the Government took 13.6 per cent in taxes, and there was left only 4.6 per cent available for preferred and common dividends to stockholders.

Aggregate value of the net assets was $23,-635,000,000, or an average of $21,200 in "tools" for each railroad employee to work with.

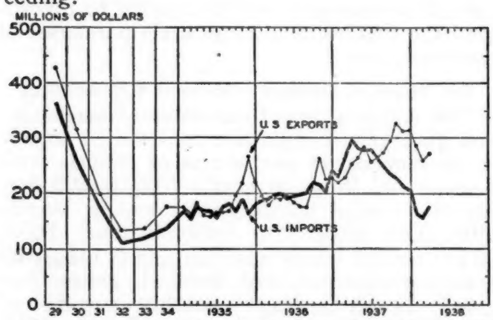
Of this total amount, $11,473,000,000 was borrowed from the railroad bondholders, who under the terms of the bonds should have received an average annual return of 4.5 per cent. In the case of bonds in default, however, the interest was merely accrued on the books, and was never actually paid to the bondholders in cash.

The railroad stockholders, numbering 876,-966, provided $12,162,000,000 of the equity capital for tools, and received an annual return upon their investment averaging only 79/100 of one per cent.

The 1,116,736 employes, who provided their services but no tools, received during the period 1930-36 an average income of 66.3 cents per hour, or $1,598 per year. With wage increases granted last year to both operating and non-operating employes, the average hourly earnings in January rose to 75.3 cents, a new peak.

Foreign Trade During the Depression

Since domestic business began to deteriorate last Summer, the outstanding development in our foreign trade situation has been the accumulation of a surplus of exports amounting to $730,000,000, or almost as much in the nine months' period from July, 1937 to March, 1938, as in the entire four and one-half years preceding.



As shown by the accompanying chart, the gain in the export balance has been brought about by the sharp decline in imports and relative stability in exports. While the latter during the first three months of this year declined as compared with the peak last Fall, due in part to seasonal factors, they were 17 per cent greater than in the corresponding quarter of last year and the largest for any similar period since 1930. Imports, on the other hand, were not only 38 per cent below those for the corresponding period of last year, but were the smallest for any similar period since 1934.

The nature of the changes that have affected our foreign trade is revealed by the following table:

United States Trade — Leading Commodities
(In Millions of Dollars)

	1936 4th Qr.	1937 1st Qr.	1937 2nd Qr.	1937 3rd Qr.	1937 4th Qr.	1938 1st Qr.
Imports*						
Agri. Prod., Total	304	410	442	357	277	233e
Competitive Agri. Prod.	149	222	255	191	115	105e
Meat & Dairy Prod.	22	30	31	29	24	19
Grains, Feeds & Prep.	39	37	42	34	5	2
Veg. Oils & Fats (†)	27	44	57	46	28	29
Sugar	20	53	65	43	24	40
Wool (†)	17	41	29	17	9	3
Non-Competitive Agri. Prod.	154	188	187	166	162	128e
Coffee, Cocoa, Tea	49	73	58	47	46	49
Crude Rubber	46	50	66	64	68	43
Silk, Raw	32	29	29	25	24	18
Metals & Mfrs.	54	66	71	74	70	40
Tin	19	28	24	24	28	11
Chemicals, etc.	23	29	28	21	25	21
Wood & Paper	69	65	79	85	77	49
Cotton & Wool Mfrs.	23	25	23	23	18	14
Exports						
Agri. Prod., Total	260	182	138	172	303	233
Meat & Dairy Prod.	14	15	14	14	19	17
Grains, Feed & Prep.	10	11	13	31	49	72
Cotton, Raw	146	106	70	64	129	79
Tobacco & Mfrs.	64	25	18	38	67	41
Machinery & Motor Veh.	166	194	236	218	241	240
Industrial	42	49	62	62	67	71
Electrical	24	25	30	28	30	26
Motor Veh., Aircraft	73	89	103	87	107	106
Other Metal Prod.	68	87	140	145	129	97
Steel Mill Mfrs. & Tools	20	24	30	31	35	25
Steel Semi-Mfrs.	18	20	32	42	42	26
Pig Iron & Steel Scrap	4	10	38	31	17	17
Non-Ferrous Metals	23	29	35	33	32	26
Petroleum Prod.	67	72	98	108	99	91
Cotton Mfrs.	8	11	11	10	12	12
Chemicals, etc.	30	31	39	34	35	30
Wood & Paper	22	28	39	37	33	24

*Imports for consumption only. e Partly estimated.
†Includes some non-competitive classes.

As to imports, the figures reveal a marked shrinkage in purchases of industrial raw materials, evidently because of the down trend of domestic manufacturing activity and the working off of inventories, along with lower prices. For rubber, silk, tin, wool and hides, leading raw material imports, we spent during the first quarter of this year about $80,000,000, in contrast to $170,000,000 expended during the corresponding period in 1937.

Good crops during the current season have reduced the need for foreign agricultural products. As will be seen from the table, the imports of grains and fodders, like those of wool, have almost disappeared, and those of vegetable oils and animal products have fallen sharply. Consequently, thanks to a better harvest, we not only spent for the so-called competitive agricultural products, from July to March, about $120,000,000 less, but we exported about $113,000,000 more of farm products than during the corresponding period of the 1937-38 season. The physical volume of farm exports

has been the largest in four seasons. Bread and fodder grains changed from a net import of some 90 million bushels in the first nine months of the 1936-37 season to a net export of almost 100 million bushels during the corresponding period of the current season.

It is estimated that for the full crop year, the diversion of our agricultural expenditures from foreign to domestic markets and our larger agricultural exports will create about $450,000,000, or nearly one-half, of the $1,000,000,000 export surplus which we shall very likely accumulate by the end of June. Of the remainder, about $300,000,000 will probably be accounted for by larger exports of machinery and metal products, $100,000,000 by increased shipments of petroleum products and the rest by reduced purchases of industrial raw materials and tropical foodstuffs.

The shipments of finished and semi-finished industrial goods which, as may be observed from the table, played an important part in maintenance of our exports, accounted in 1937 for about 70 per cent of total exports, a larger proportion than in any previous year. These shipments reflected the high industrial activity in Europe and the relatively prosperous conditions in raw material countries during a greater part of 1937. However, with the signs of a downward trend of business all over the world multiplying, the prospects for our exports have grown decidedly less bright since the turn of the year.

The relative stability of exports has been in striking contrast to the trend during the 1929-1932 depression, when sales abroad gave little support to the business situation at home. Ordinarily the exports, in the aggregate, contribute only a small fraction, probably in the neighborhood of 10 per cent, of the total domestic business. This proportion has undoubtedly risen since last July, in view of the decline of 35 per cent in domestic industrial activity. In some lines, such as machine tools, foreign orders accounted for over 50 per cent of the total new business during the month of March. The exports of farm machinery and implements during the first quarter of 1938 exceeded the 1937 level by 36 per cent, while motor vehicle exports amounted to 112,000 units, or 18.2 per cent of total factory sales, against 116,000 units, or 9.7 per cent of total sales, in the corresponding quarter of 1937. Export copper deliveries during the first quarter were nearly twice as large as a year ago.

The Trend of Steel and Machinery Exports

Although the iron and steel output outside of the United States established a new record in 1937, metal products and machinery contributed almost two-thirds of the $876,000,000 increase in our exports last year. The rise of industrial activity abroad, greater purchasing power of raw material countries, and above all, the accelerated demand for war equipment in the Spring of 1937, resulted in record breaking exports of our steel scrap, pig iron, tin plate, and in a sharp gain in shipments of steel ingots, plate and rails.

Since the latter part of 1937, foreign steel demand has tended to ease off, due to bringing in of increased capacity abroad and lessened pressure from private consumers. In Great Britain, where early this year steel output reached the highest level in history, the congestion of orders has been relieved so much that the import duties on pig iron and steel semi-manufactures, removed in the Spring of 1937 to relieve the shortage of raw materials, have been restored since April 1, 1938.

While the outlook for exports of iron and steel has grown somewhat uncertain, prospects for machine tools, motor vehicles, aircraft and industrial machinery are still promising. The last six months exports were the best of any similar period since 1929 for American manufacturers of machinery. The largest gains in the exports during 1937 took place in construction and conveying equipment (excavators), power generating equipment, tractors and agricultural machinery in general. During the first quarter of 1938 the aircraft and metal-working machinery exports were practically twice as large as last year.

The exports of armament equipment, including motor trucks and aircraft, are likely to continue because the armament race abroad is lacking home production facilities. In Great Britain a difficulty is the shortage of skilled labor; in France, low labor productivity; and in other countries, either deficient raw material resources or lack of specialized plant equipment. About 60 per cent of 1937 sales of the aircraft industry which were the largest on record, consisted of military equipment. Last month the British Air Ministry sent a special commission to this country to investigate the feasibility of large scale purchases of military aircraft.

Our Share of Foreign Armament Expenditures

The stepping up of our sales of machinery and general war materials contributed largely to an increase in our excess of exports with Europe and Japan to nearly $850,000,000 during the twelve month period ending March, 1938. Our trade with Great Britain, almost 50 per cent of which now consists of industrial semi-manufactures and finished goods, has given us an average monthly surplus of $48,000,000 since last October. During 1937, we supplanted Algeria as the leading source of French imports; in the Netherlands and Belgium we advanced to third place, in Poland we tied for the second place with Great Britain, but in Germany we were displaced by Argentina and Italy we lost proportionately to Great Britain and Germany.

The following table, comparing our trade by countries, indicates the shift that has taken place in our commerce with raw material producers, due principally to the decline of imports, but in part also to some rise of exports. This shift has been particularly marked in the case of Australia and Argentina, which, together with the South African Union, are our leading markets for passenger cars, trucks, tractors and agricultural machinery in general. Our exports to Argentina rose 66 per cent in 1937, outranking in the last few months those of Great Britain, hitherto the leading source of Argentine imports. We displaced Germany as the chief supplier of Chilean imports, increased our lead in Peru, almost doubled our exports to Dutch East Indies and Venezuela, but proportionately lost ground in the Colombian trade. Our exports to Latin America rose from $395,000,000 in 1936 to $578,000,000 in 1937, or 46 per cent. The 1937 sales to South Africa, Congo, French West Africa and Dutch West Indies established a new record. However, unless our imports from these countries again pick up, a reduction sooner or later in their purchases from us would appear to be inevitable.

United States Trade, By Countries
(In Millions of Dollars)

	1936 4th Qr.	1937 1st Qr.	1937 2nd Qr.	1937 3rd Qr.	1937 4th Qr.	1938 Jan.-Feb.
Imports From:						
Chiefly Raw Material Prod.						
Canada & Newfoundland	117	102	111	108	87	38
Central Am. & Carib.	43	85	92	62	44	40
Mexico	12	18	17	14	11	8
Cuba	17	46	52	31	19	21
South America	82	123	120	101	78	46
Argentina	23	43	43	37	16	9
Brazil	29	33	29	31	28	18
Asia (exc. Japan)	129	181	213	189	180	87
China & Hongkong	16	32	35	27	19	8
Malaya & India	63	77	94	83	85	38
Africa	14	28	31	19	14	7
Australia & Oceania	7	30	20	11	7	2
Eastern Europe	19	27	23	25	27	17
Total	411	576	610	515	437	238
Chiefly Industrial Prod.						
Japan	47	54	57	48	45	20
West. & Cen. Europe	198	194	193	180	175	75
U. K.	61	58	54	46	45	19
France	20	20	19	17	20	8
Germany	24	22	23	24	24	10
Italy	14	12	13	10	13	5
Total	245	248	250	228	220	95
Total Imports*	656	824	860	743	657	333
Exports To:						
Chiefly Raw Material Prod.						
Canada & Newfoundland	109	102	146	140	131	62
Central Am. & Carib.	64	73	82	81	85	49
Mexico	21	24	30	29	26	15
Cuba	18	22	23	22	25	14
South America	58	62	76	83	97	52
Argentina	17	17	23	25	29	16
Brazil	14	13	16	17	20	11
Asia (exc. Japan)	52	63	71	74	84	51
China & Hongkong	14	17	19	17	17	10
Malaya & India	9	10	11	13	18	10
Africa	34	30	40	42	39	24
Australia & Oceania	17	21	23	27	28	14
Eastern Europe	18	19	26	23	33	20
Total	352	370	464	470	497	273
Chiefly Industrial Prod.						
Japan	67	77	88	69	54	40
West. & Cen. Europe	304	263	275	303	414	242
U. K.	144	108	100	135	192	112
France	44	39	36	38	51	24
Germany	30	25	29	30	40	17
Italy	17	20	20	18	19	11
Total	371	340	363	372	468	281
Total Exports†	723	710	827	842	965	554

*General imports. †Including Re-exports.

Excess of Exports and Capital Movements

The striking gain in our export business from July, 1937, through March, 1938, tended to create an international balance of payments heavily in our favor. Nevertheless, the pressure during most of this period was on the dollar rather than on foreign currencies, with only a small quantity of gold moving to our shores. This was due to the fact that the accumulation of exports was more than counterbalanced by a heavy outward movement of capital between the end of September and the early part of March. As was recently revealed by a Treasury report, the withdrawal of foreign capital, presumably caused by fear of inflation in this country, amounted to more than $500,000,000 during the last quarter of 1937 alone. When the capital flow was reversed early in March, 1938, following the war-scare in Europe, major foreign currencies found themselves under heavy pressure, accentuated by the fact that the international payments originating from commodity and service accounts have been in our favor.

Disturbance in the silver markets in the latter part of 1937, caused in part by rumored change in our policy and in part by war in China, resulted in exceptionally heavy purchases of foreign silver by the United States Government in the last quarter of 1937 and the first quarter of 1938. These purchases likewise cut down our surplus of payments from commodity and service accounts. In addition to regular purchases of newly-mined silver, the Treasury absorbed in the last six months some 35,000,000 ounces from accumulated stocks of the National Bank of Mexico and about 130,000,000 ounces of Chinese silver. The latter is a part of some 330,000,000 ounces of silver which, in the form of silver coin, was shipped from Shanghai via Hongkong to London since the outbreak of the Far Eastern war.